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The
Morgan Guaranty Survey

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This month's Survey *is entirely devoted to one topic: the prospects and problems facing the U.S. economy.*

- *What lies ahead for the recovery as it moves into its second year?*
- *What of secular trends that will dominate the outlook beyond 1984—inflation, wages, productivity, capital investment?*
- *And what of the larger challenges that need to be met if the 1980s are to produce sustained growth? Key among these is a federal budget that is out of control and a monetary policy that needs redefinition.*
- *Yearend review and outlook for the economy sector by sector, with detailed quarterly projections.*

The Economy in 1984—and Beyond

THE recovery, now a year old, has been both routine and surprising. With real GNP growing an estimated 6½% over the past four quarters, the pace of expansion has been roughly in line with the typical postwar experience (chart on page 2). But the economy's ability to forge ahead (actually at double the rate of last winter's consensus forecast) despite historically high interest rates and a sharp deterioration in this country's external accounts sets this recovery apart from any since the end of World War II. So does the striking shift in the composition of national income—toward profits and away from personal income. This shift will have a significant influence on capital investment and on the pace of the recovery in its second year.

The Morgan Bank projects continued cyclical advance in 1984, with real-GNP growth of about 4½%, fourth quarter to fourth quarter (table on page 2).

Against the background of major surprises in 1983, continued advance in the economy—while the most likely expectation—cannot be taken for granted. One obvious source of concern is the fragile debt condition of developing countries. Another is the policy drift in Washington on ways to narrow massive budget deficits. A further uncertainty is the still unsettled state of Federal Reserve policy.

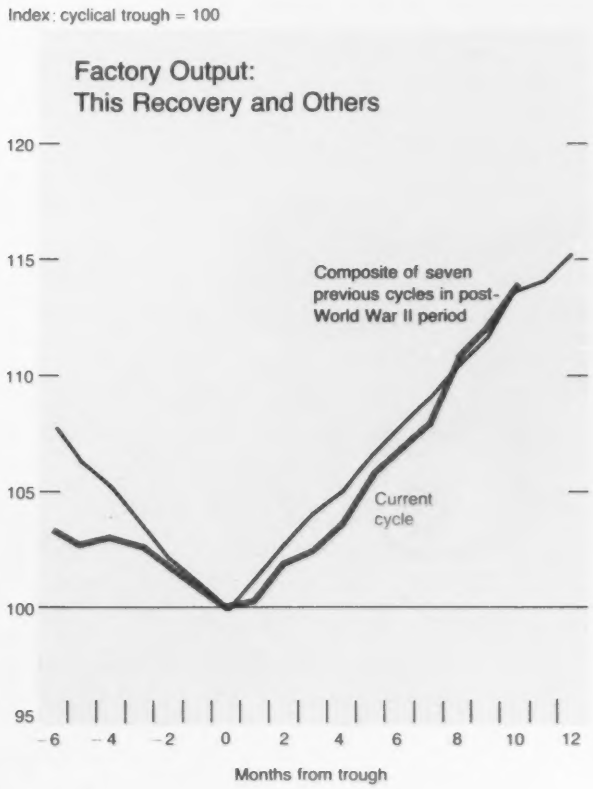
Having backed away from strict targeting procedures for monetary expansion—because of the severity of the recession—the Fed is in a much looser posture in which judgment and flexibility seem paramount. The practical considerations (including the delicate international debt situation) that argue for such a posture at this time are impressive. The consequence, how-

ever, is that no one can be sure what long-term strategy the Fed will be able to develop to consolidate and improve on inflation gains now that economic activity is expanding.

Farther down the road—1985 and beyond—the doubts and unease that cloud the outlook will not diminish unless confidence develops that policy makers have the skill, scope, and resolve to fashion an appropriate policy. For the present, the crucial question of whether the progress realized on the inflation front during the recession will prove lasting remains open.

Looking back—briefly

The vigor of the recovery caught most analysts by surprise. In retrospect, excessive attention was paid to the potentially inhibiting effects of high interest rates. There was also a tendency to forget just how powerful, at least for a time, the self-extending thrust of a cyclical upturn can be.



Note: The trough month for this cycle is November 1982

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

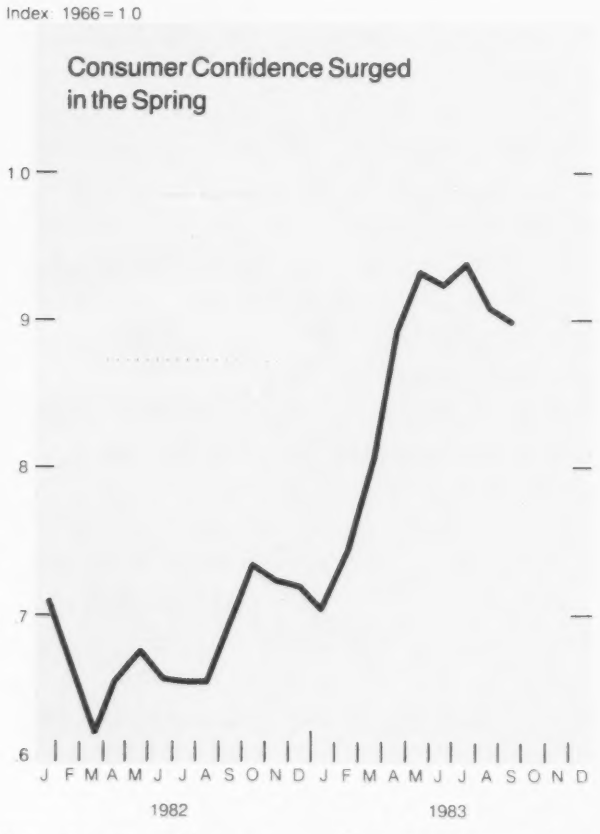
	1983	1984			
	Q4	Q1	Q2	Q3	Q4
Real GNP	5.5	4.6	4.5	4.7	4.5
Real consumer spending	5.0	4.1	2.9	3.1	2.9
Real business-capital outlays	11.9	10.0	9.3	8.6	10.0
GNP deflator	3.9	4.8	4.6	4.4	4.9
Consumer prices	4.9	4.9	4.6	4.5	4.5
Real disposable personal income	4.6	2.1	2.8	3.0	3.5
Saving rate (%)	4.6	4.2	4.2	4.1	4.2
Housing starts (Millions)	1.7	1.7	1.7	1.7	1.8
Auto sales (Millions)	9.8	10.0	10.1	10.3	10.4
Unemployment rate (%)	8.9	8.8	8.8	8.6	8.5

In the last half of 1982, accommodative Federal Reserve policy resulted in money growth well in excess of established targets and caused a sharp drop in interest rates—about six percentage points for short rates and three percentage points for long rates. Even though such declines left credit costs unprecedentedly high for the end of a recession, the declines from earlier heights helped make housing more affordable. And, in combination with a rising stock market, they produced a turnabout in the national mood.

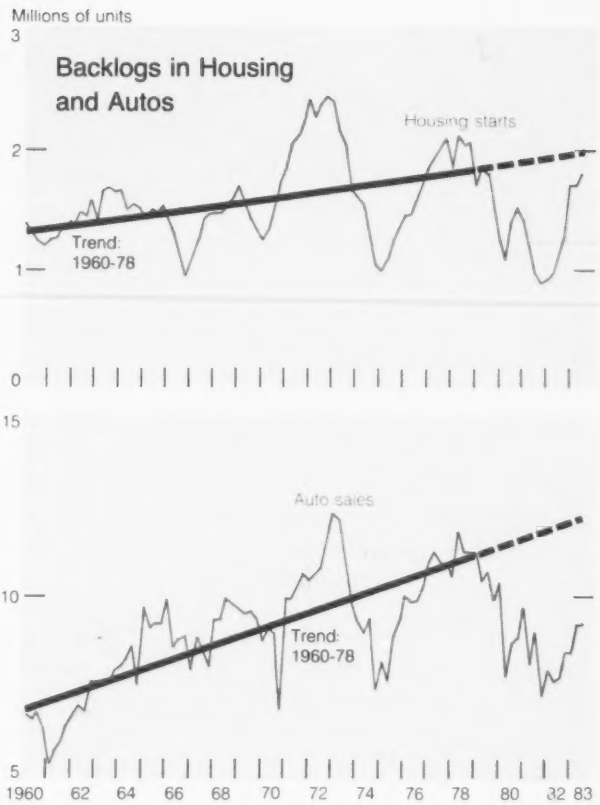
The stimulus of sharply lower interest rates in the second half of 1982 was not evident for a while because businesses remained intent on reducing inventories. Gradually, however, expan-

sion took hold in housing and autos, reinforcing the support to business sales coming from the defense buildup. By late 1982, with overall final demand rising and inventories much reduced, the stage was set for a rebound in production.

Growth in residential construction and the start of an easing of inventory liquidation pushed real GNP upward in the first quarter of 1983 and brought about the welcome surprise of a sharp drop in unemployment. Consumer sentiment rebounded, as shown in the chart below. As consumers lost their fears, recovery in housing and autos accelerated and strength in household spending broadened, producing a rise of 10% at an annual rate in real personal consumption expenditures in the second quarter—the largest quarterly gain in almost 20 years.



Note: Consumer confidence as measured by The Survey Research Center at the University of Michigan.



An important element in the household-spending surge, one that was greatly underweighted in economists' 1983 projections, was the pent-up demand that accumulated during 1980-82 when acquisitions of autos and the number of new housing units coming onto the market fell below long-term trends (accompanying chart). This pent-up demand is probably far from exhausted and is likely to remain a sustaining influence in the economy (interest-rate levels permitting) well into the future.*

*Measurement of pent-up demand is difficult, especially in the case of autos where long-term trends may have been affected significantly by "oil-shock" factors. However, the average age of the car on the road (now seven years) has moved so significantly above the norm as to suggest that car sales ought to be biased upward whenever the general economic environment is not adverse. In the case of housing, demographics suggests that when cyclical recovery began in the economy the backlog of housing demand was equivalent to as many as a million starts. That still seems to be a good working estimate of the current backlog.

Self-feeding tendencies (which recently have begun to induce a decisive recovery in business investment) have limits, of course. Certainly in 1984, dynamic cyclical forces are likely to be less powerful than they have been this year. Indeed, some downshifting in the rate of economic advance seems to be in progress. This partly reflects the rise in both short- and long-term interest rates that occurred last spring and summer when the Fed tightened reserve availability moderately and investors reacted negatively to signs that fiscal policy was stalemated.*

Among the reasons for anticipating a slower pace of advance in 1984 than in 1983:

• The inventory rebound, involving a move from sharp drawdowns late in 1982 to fairly rapid accumulation now, seems largely spent. Inventory-to-sales ratios are still low in historical perspective. But most businesses, mindful of high carrying costs, seem intent on keeping inventories as low as possible, consistent with efficient marketing. Whereas the inventory rebound has accounted for nearly 40% of the rise in real GNP over the past year, inventory behavior is likely to be an essentially neutral influence in the economy in 1984.

• Consumers are unlikely to be as active as they were in last spring's buying spree. Having let their saving rate slip to a 20-year low, consumers lack the ability they once had to increase their spending more rapidly than income growth. Household wealth remains high in an absolute sense, but further wealth increases of the size that occurred in the major runup of stock and bond prices in 1982-83 seem unlikely. With the growth of real consumer income settling down to a pace of 3% or thereabouts (reflecting moderate wage gains), that is probably the most reasonable growth rate to project for real personal consumption expenditures during 1984.

Sources of Growth During Recoveries

	Typical Cycle	*Current Cycle*
Percent of growth accounted for by:		
Consumer expenditures	51.8	53.7
Residential construction	16.5	22.1
Business investment	7.1	11.1
Net exports	−4.3	−19.4
Inventory investment	25.0	37.3
Government purchases	3.9	−4.9

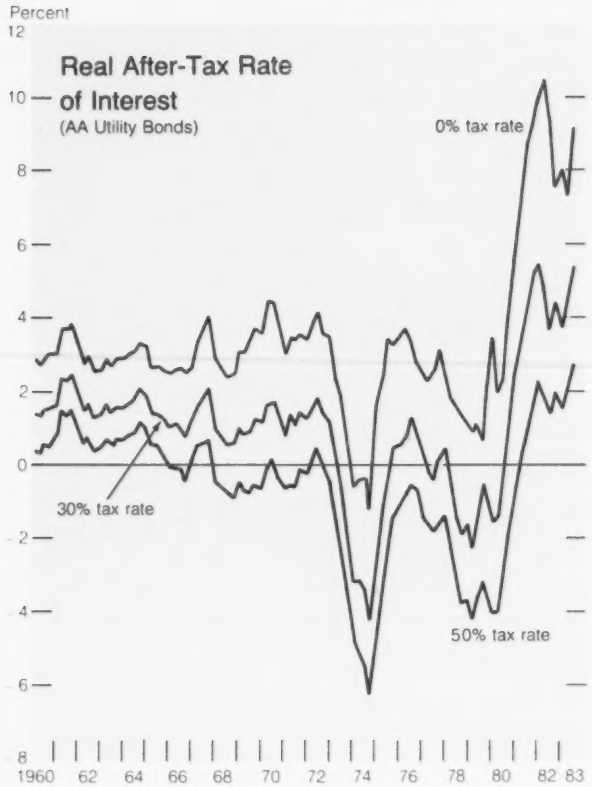
Note: Figures for the typical cycle are averages for the first three quarters of the seven previous postwar business recoveries. Figures for the current cycle are from the fourth quarter of 1982 to the third quarter of 1983.

• The loss of a lot of the earlier zip in housing is also a significant omen for the broad economy in 1984. This year, surging outlays for residential construction accounted for about one-fifth of the rise in real GNP. Next year, however, housing looms as an essentially neutral factor, with starts likely to average about 1.7 million units, the same as in 1983.

The housing outlook reflects the balancing of several conflicting forces. On the plus side, demographic factors remain favorable, as the peak of the postwar baby boom is just now entering the age categories that normally supply

*The roughly 150-basis-point rise that occurred from May to July in long rates (which, very atypically, was larger than the Fed-triggered rise in short rates) was a significant development as far as the recent performance of the economy is concerned. It quickly weakened housing activity as monthly carrying charges on a median-priced house financed with a 75% mortgage loan rose by $80 per month.

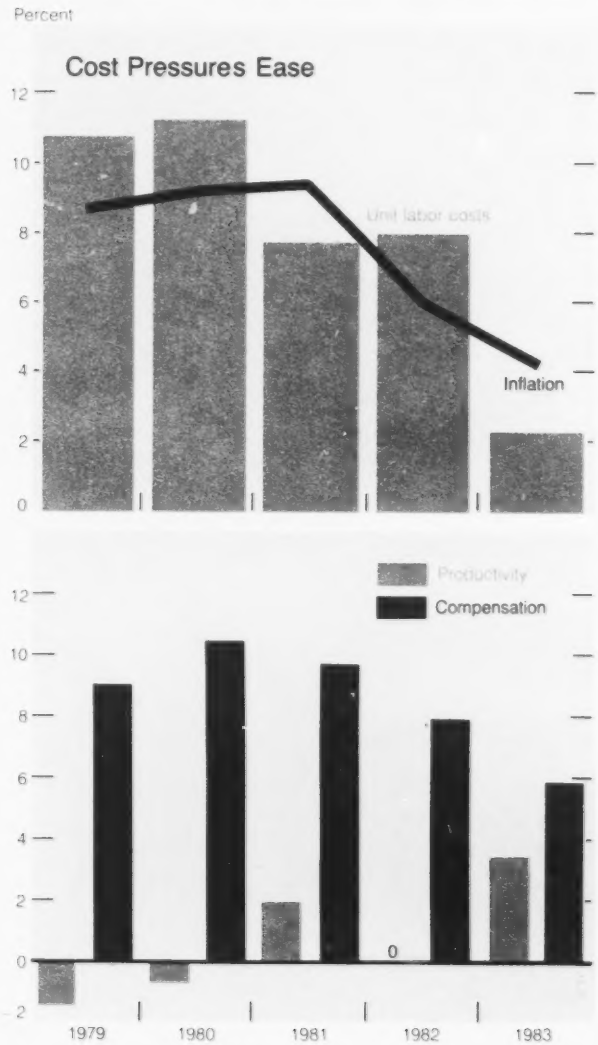
The important message in this is that the shift in Fed policy during the spring (which ordinarily would not have caused or been accompanied by anything like the change in long-term rates that took place) was not solely responsible for the downshifting of economic growth. Indeed, hints of downshifting in the economy in the last few months may very well have created a misleading impression of the conditioning influence of moderate changes in Fed policy.



Note: The four-quarter increase in the personal consumption deflator was used to calculate the real interest rate.

most first-time home buyers. Moreover, with the deregulation of deposit-gathering by financial institutions now largely complete, and with expanded secondary mortgage market mechanisms firmly in place, availability of financing is not likely to pose a serious problem. In addition, the growing popularity of adjustable-rate mortgages with lower initial carrying charges than those on fixed-rate mortgages ought to help sustain demand.* At the same time, however, costs of ownership remain high, and rising vacancy rates bode ill for a continuation of this year's unusual strength in building of rental units.

To be sure, there are offsets to the forces that will moderate the economy's growth in 1984. Most important, signs are growing that business outlays on new plant and equipment will provide strong support. This is particularly promising because profitability has been rising at an unusually fast pace, partly reflecting the pronounced shift in income away from personal in-

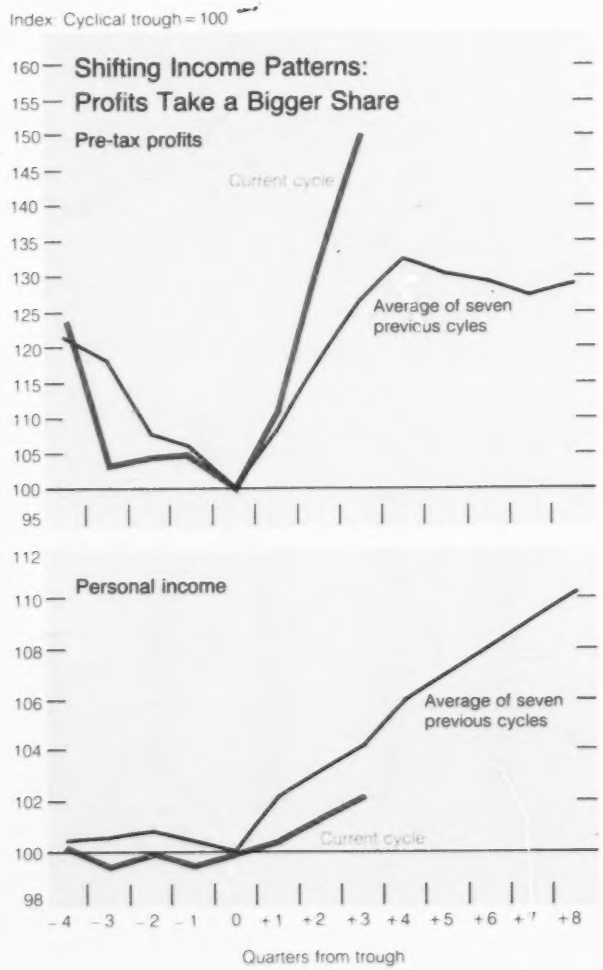


Note: Figures relate to the private nonfarm economy. Inflation is measured by the GNP deflator. The 1983 figures are estimated from three quarters of data.

*Home buyers have been showing a tendency to shift toward use of adjustable-rate mortgages in rising interest-rate situations. Data of the Federal Home Loan Bank Board indicate that 45% of commitments made in September for future mortgage lending involved adjustable-rate mortgages, up from 30% last spring. Nationwide, the initial effective interest rate on adjustable rate mortgages is averaging about one percentage point less than on fixed-rate mortgages.

come and toward profits (accompanying chart). Profits of nonfinancial corporations, adjusted for inflation, currently represent a higher percentage of output than they have at this point in the business cycle in any other recovery since the early 1960s.

Contributing to the rebound in profitability are a number of factors. Pretax profits have been helped by the moderate uptrend in wages and by the intensive cost-cutting efforts many firms have made in the past few troubled years. After-tax profits have been helped by tax-law changes and by the fact that, as inflation has moderated, corporations are being taxed on a greatly reduced volume of inflation-induced "phantom"



earnings. The effective tax rate on the economic profits* of nonfinancial corporations is now at its lowest point in 30 years (chart on page 7).

The strong showing of profits means that corporations are positioned for a time to finance capital projects with relative ease. And the promise of attractive returns on additional spending favors investment undertakings. Capital-goods ordering has already accelerated significantly, showing more strength at this stage of the business cycle than is normal. With operating rates in industry rising in the past year to approximately 80% on average, real business investment could easily be up 9% to 10% during 1984 (fourth quarter to fourth quarter). Such an increase might well account for more than a fifth of total real growth in the economy in the coming year.

Additionally, lessened weakness in the nation's external accounts should help to keep the economy moving forward. A dramatic turnabout toward stronger exports and weaker imports does not seem to be in the offing—not with the U.S. dollar 30% higher (on a trade-weighted basis) than it was three years ago against the currencies of this country's major trading partners. But at least most of the hobbling effects on recovery that have come from the external accounts seems past.

This is important because, without external-account weakness, real GNP would have risen during 1983 by close to 8% rather than 6½%. The steep slide in U.S. exports appears to be slowing, helped by vigorous economic recovery in Canada (this country's largest trading partner), and by at least moderate recovery in a number of other industrialized countries. Moreover, the sharpest import curtailment seems over

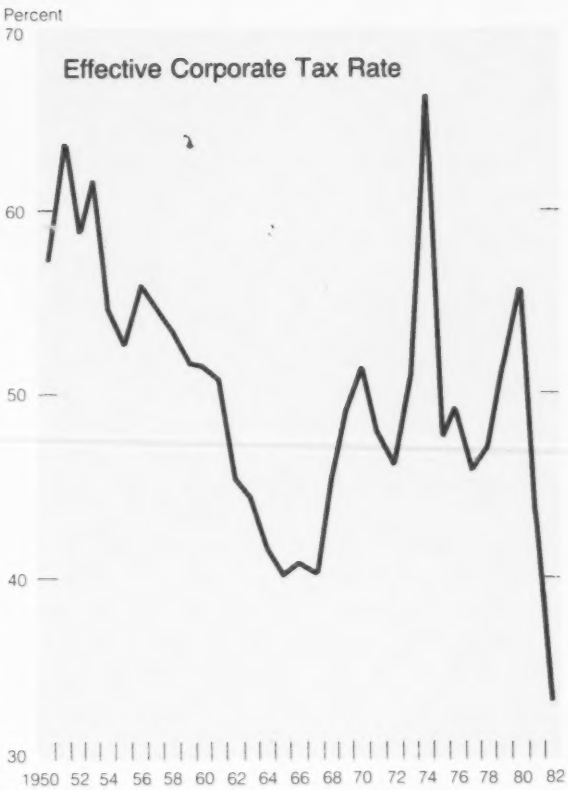
*Economic profits adjust for inventory profits caused by inflation and treat depreciation on a replacement-cost basis.

in Mexico and in some of the other troubled developing countries that trade heavily with the U.S. With moderate depreciation of the dollar (on the order of 5% to 10% by the end of 1984*), it is not unreasonable to think that, on a fourth-quarter-to-fourth-quarter basis, net exports (exports less imports) will have a neutral effect on GNP in 1984.

Finally, government spending is likely to support economic growth in the year ahead. Significantly, defense spending, in real terms, should rise by more than 6% in 1984, down only slightly from 1983. And state and local government spending, which grew modestly in 1983, is likely to provide considerably more lift for the economy. Collectively, state and local government budgets are beginning to show surpluses, due in part to the economic recovery and in part to the payoff from austerity measures adopted during the recession. Given this trend, states and localities can be expected to move ahead more aggressively in attacking the backlog of unmet infrastructure needs.

All in all, prospects for key sectors of the economy suggest a slower growth rate for real GNP during 1984, but one that at 4½% would nevertheless be slightly in excess of the average for the second year of cyclical expansion.

Inflation in 1984 is not likely to be as low as in the past year. An especially moderate increase in the price level during 1983–3¼% measured by consumer prices and 4% by the GNP deflator–was the product of factors not likely to recur: a midwinter slump in oil prices, generally well behaved food prices, and the significant strengthening in the dollar. Against that background, it would not be surprising to see a modest rise in inflation. The Morgan Bank's forecast is for both the GNP deflator and the consumer price index to advance a little less than 5% in the year ahead.



Note: Tax liabilities relative to profits excluding inventory profits and with depreciation calculated on a replacement cost basis for the domestic operations of nonfinancial corporations

Details of The Morgan Bank's 1984 forecast are shown in the table on page 2. Moderate growth ought to produce relatively stable interest rates (box on page 8).

Longer-run challenges

The year 1984 promises to be an in-between year–one when the economy will have moved out of recession but will not have fully encountered the pressures that come with high operating rates. The years 1985 and 1986, however, loom as potentially troublesome years that will test whether the discipline of recession

*A moderate dollar depreciation of this magnitude is an explicit input to The Morgan Bank's 1984 economic forecast.

INTEREST RATES IN 1984

ALTHOUGH interest rates normally trend upward in a cyclical expansion as demands on resources and on saving intensify, there are four major reasons for expecting relatively stable rates in 1984:

1. Generally satisfactory economic performance (moderate growth, declining unemployment, and relatively subdued price pressures) would probably leave the Fed disposed to continue its essentially neutralist course.

2. With the economy's demonstrated sensitivity to change in interest rates, deviations in either direction from current levels will tend to be self-limiting. As the experience last spring and summer pointed up, even moderate upward pressures on already high interest rates can diminish some of the economy's vitality—largely through slowing housing activity. That subduing effect, in turn, would ease the rate pressures themselves. And the robustness that had developed in the economy earlier this year, when rates were only slightly lower than they are now, hints that any decline in rates from prevailing levels would also be self-limiting—since demand pressure would heighten bidding for funds.

3. Worrisome as is the federal deficit problem for the longer run, there are indications that market tensions between public and private credit demands are currently at bay. In particular, the impressive improvement in profitability now under way means that corporate external financing needs (the need for funds over and above funds generated internally) will remain relatively small throughout much of 1984 (chart on page 10).

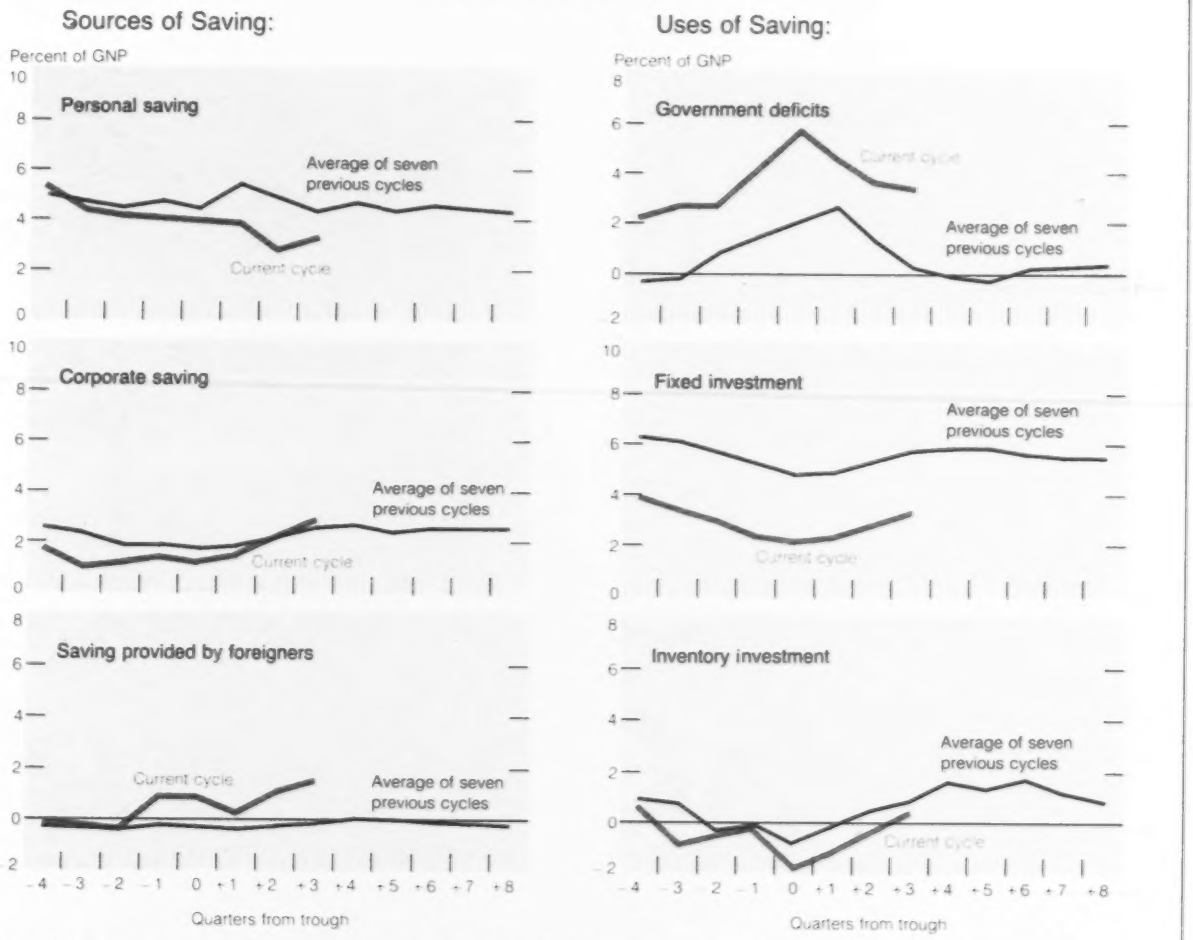
4. The fragility of the international debt situation is probably creating a disposition on the part of the Fed to limit upward interest-rate movements. This is because even marginal additions to interest burdens could be very troublesome at this stage for a number of developing countries. Indeed, higher interest rates in the U.S. would be unwelcome among developed countries as well, because of the slowness of their economies to recover and the intractability of unemployment (chart on page 15). While international-debt considerations may dispose the Fed to constrain upward pressures on rates that may develop, they probably do not give the Fed much reason to initiate interest-rate declines. As a practical matter, the Fed could not engineer enough of a decline in rates to improve debtors' positions materially. If it tried to do so, inflation expectations very likely would explode. The Fed, in short, may be capable of preventing troublesome deterioration at the margin, but it cannot hope to cure the debt difficulties of developing countries by being permissive.

(together with the various supply-side initiatives that have been legislated) has put the economy permanently on a sounder basis.

One could feel more certain of a good outcome (and less worried about a new recession developing in a year or two) if serious moves were afoot to make the federal government a smaller borrower, and a smaller user of resources, in the years stretching into the late 1980s. Because of the current fiscal stalemate, the major risk is that total public and private demand for credit, and for real resources as well, will eventually become too large to be accommodated without considerable tensions in financial markets and significant upward pressure on interest rates. It may well be possible to get through 1984 without such tensions, but it is difficult to feel confident that they can be avoided indefinitely.

Judgments about the severity of the risk are complicated not only by the difficulty involved in forecasting budget deficits but also by lack of consensus among economists on the correct theoretical framework for analyzing the prob-

The Saving Balance

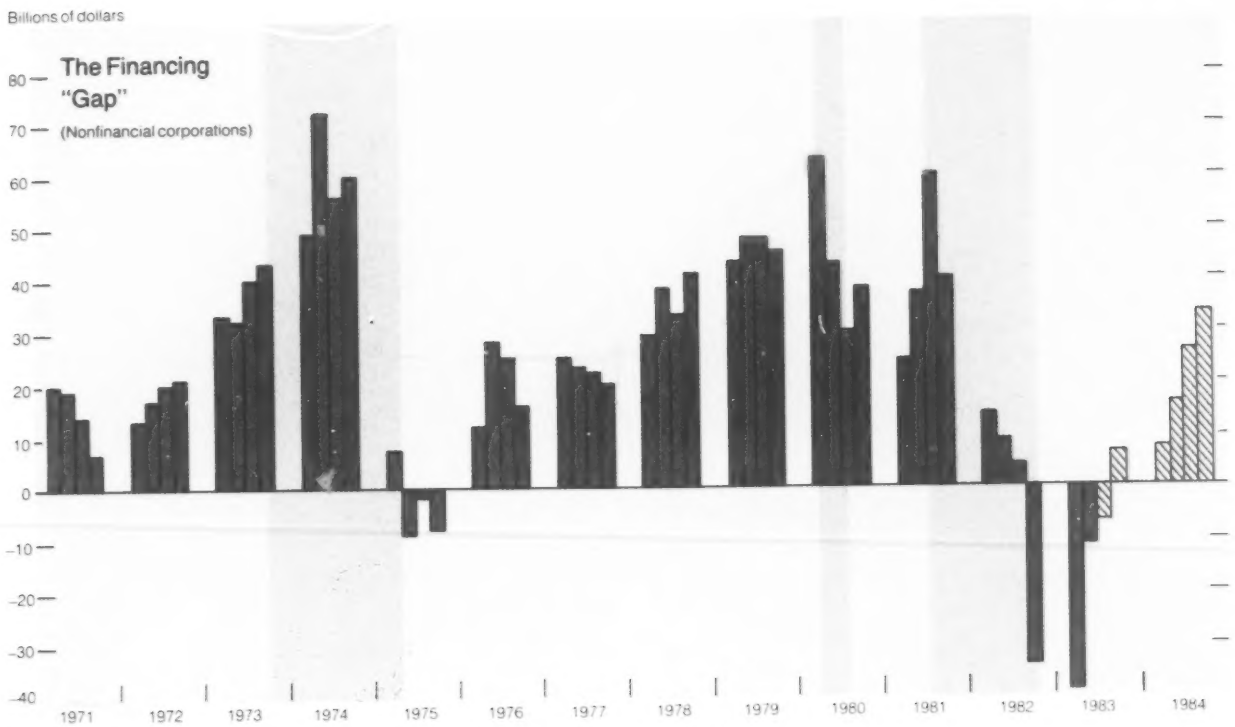


Note: All saving and investment figures are shown net of depreciation and thus represent the amount of saving and investment that is potentially available to expand the existing capital stock. If the figures were on a gross basis, that simply would lift both fixed investment and the sum of personal and corporate saving by equal amounts.

Government deficits include state and local government operating balances and accumulations in public pension plans as well as federal government deficits. If public pension plans were treated the same way as private plans, the level of budget deficits would be boosted by approximately one percent of GNP and personal saving would be boosted by the same amount. Saving provided by foreigners is essentially the mirror image of the U.S. international current account balance. Corporate saving is retained after-tax profits.

lem. Economists even differ widely on how deficits should be measured.

One way of looking at the danger posed by large deficits is by examining the way in which the economy's supply of saving (coming from individuals, corporations, and foreigners who invest here) gets allocated among various uses (inventory investment, residential construction, plant and equipment spending, and financing government deficits). The charts on this page show how savings sources and savings uses (calculated as a percent of GNP) now compare with average source-and-use patterns in past business cycles.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research.

The financing gap is the difference between corporate outlays for fixed investment and inventories and retained cash flow (depreciation plus after-tax profits minus dividends).

What stands out in the current figures is that fixed investment (residential and nonresidential) is running roughly two percentage points below what is normal for this stage of the cycle. At the same time, the government claim on saving (federal and state and local governments combined) is running roughly three percentage points higher. Personal saving has been lagging well below that of earlier years, while corporate saving has recovered very strongly. Saving provided by foreigners is unusually high, reflecting current large flows of capital to the U.S. from abroad.

The concern is that if government deficits continue at roughly 4% of GNP or higher (a likely prospect unless major deficit-reducing measures are taken by Congress) there will simply not be enough saving to restore private-sector uses of saving to the levels that are normal as economic expansion proceeds; competition for available funds would raise interest rates and curtail investment. Housing, small business undertakings, and the programs of states and localities would be disproportionately affected, and the risks of renewed recession would be high.

Even if a recession were to be avoided, a new upward interest-rate move could jeopardize the upswing in capital investment that is now under way. Cost-cutting—in response to rising imports, deregulation, and the recession—has been one key factor behind the recent productivity rebound. The underlying trend in productivity, as the table on page 11 shows, appears to have reaccelerated from the no-growth situation of the late 1970s to the range of 1.5% to 2.0% per year. Such a rate of advance is still somewhat below the 2.5% trend of the 1960s,

but the improvement that has occurred is extremely important. If the positive trend is to carry through, plant-and-equipment modernization and expansion need to continue.

Tensions in credit markets thus far have been muted by a number of factors that cannot be counted on indefinitely. The strong growth in corporate profitability, it is true, has enabled firms to finance capital programs with minimal dependence on external funds. But, as the growth in earnings settles into a more normal pattern and as business investment accelerates, firms eventually will have to turn to credit markets for funding. Also, the foreign inflows of funds which have helped to ease the pressures in credit markets that otherwise would have surfaced cannot be taken for granted on a continuing basis. If, as expected, recovery outside the U.S. gains momentum and the dollar loses some of its strength, investors abroad will bid less actively for U.S. securities and they might even reduce their holdings.

Federal Reserve officials clearly are worried —understandably so—about the potential that exists for a clash between public and private demands for credit and for real resources. The Fed, of course, could try to resist renewed upward pressure on interest rates by being accommodative in supplying reserves. If it did so, however, it would nurture inflation and reignite inflation expectations. The hard-won gains in the battle against inflation in the past few years could be lost quickly.

Monetary strategy

Given this dilemma—and the additional complication that exists because of the fragile international debt situation—it is difficult to foresee precisely how Fed policy is going to evolve from its present relatively neutralist stance to something that credibly promises renewed disinflation in the economy. Between 1979 and 1982, the Fed did have a highly credible and effective disinflation policy in place. But, by mid-1982, it was forced by the severity of the recession to abandon rigid targeting of the monetary aggregates and shifted its focus to the performance of the economy.

This shift made sense because of the major distortion in the monetary aggregates that was caused by new deposit instruments and continuing interest-rate deregulation (box on page 12). And the shift has introduced a welcome degree of flexibility into monetary policy. But the cost has been uncertainty about the Fed's resolve to

(Continued on page 14)

Productivity: Actual and Cyclically Adjusted

(Percentage change)

	Actual	*Cyclically adjusted*
1970	0.5	2.2
1971	3.3	2.8
1972	3.7	2.3
1973	2.4	2.0
1974	−2.5	−0.9
1975	2.0	3.7
1976	3.2	1.5
1977	2.3	1.4
1978	0.6	0.3
1979	−1.5	−1.2
1980	−0.7	0.8
1981	1.9	1.7
1982	0.0	2.1
1983 (proj.)	3.1	1.3
1984 (proj.)	2.3	1.7

NOTE: Productivity figures cover the private nonfarm sector of the economy.

GAUGING MONETARY POLICY: AN EXPERIMENTAL MEASURE

HAS monetary policy been "easy" or "tight" this year? Different measures give different answers.

To many, rapid growth in M1—until recently the Federal Reserve's main monetary target—is proof positive of a continuation of the easing that began in July of last year. "Real" M1 (that is, M1 adjusted for inflation) rose 9.5% between July 1982 and July 1983, following a 0.7% drop in the preceding twelve months.

But real interest rates seem to convey a different message. Measuring real rates is difficult because there are no adequate gauges of inflation expectations. But by the measure depicted in the chart, after dropping substantially from their extraordinary 1982 levels, real rates have remained high, suggesting that monetary policy has remained tight.

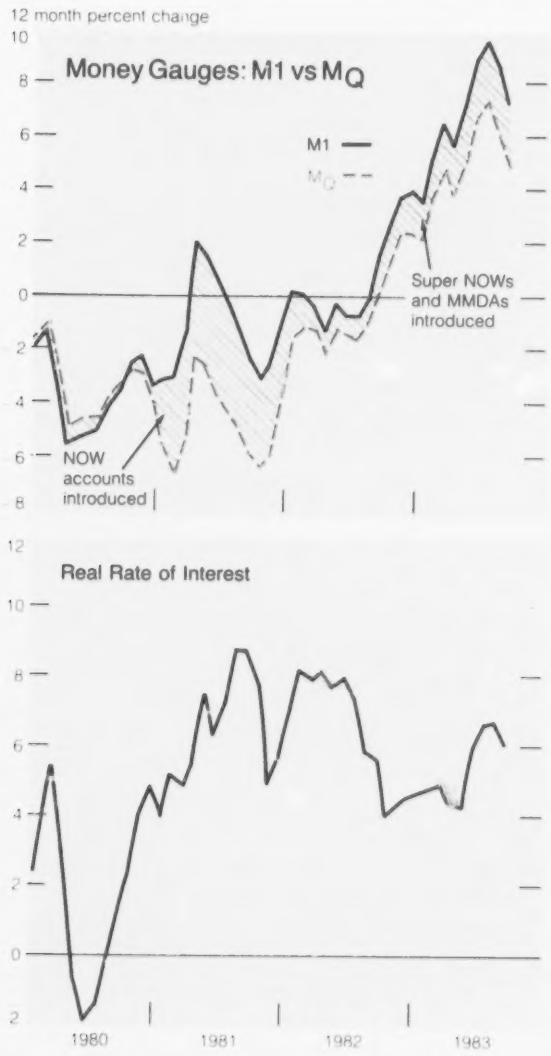
One reason for the conflicting policy interpretations is that money—like the old grey mare—just ain't what it used to be. New deposit accounts—NOWs and Super NOWs—have fundamentally altered the meaning of M1. That is because each of those new deposit vehicles lumps together funds that have savings characteristics with funds that have transactions characteristics. No longer is M1 the transactions-oriented measure that it once was. Moreover, money market deposit accounts, which also include both transactions and savings characteristics, have siphoned funds out of M1.

All this may seem like arcane economist's stuff, but it has profound implications for monetary policy. Indeed, one major reason that the Fed scuttled mechanical monetary targeting is that officials could no longer make confident judgments about the appropriateness of a given M1 growth because they were unsure of the meaning of distortions caused by the new accounts. Exactly how much transactions money were they creating?

This clearly is not a very happy state of affairs. Ideally, what is desired is a distortion-free aggregate. The search for such a measure has spawned a great deal of experimental work.

One such experiment has been undertaken by Fed economist Paul Spindt. He has attempted to identify the portion of each M1 component that is associated with purchases counted in GNP. To do that, he has studied both the patterns of cash usage and bank-debit data. The results provided the basis for estimating what portion of each component of M1 is used to acquire things other than existing assets (real or financial) and "intermediate goods" (for example, raw materials that ultimately are incorporated in a finished product). Spindt concluded that each dollar of demand deposits does roughly three times the work of each dollar of NOW balances in financing end-product GNP. Accordingly, he gave demand deposits three times as much weight as NOWs in his experimental measure of transactions money (which he dubs M_Q). He similarly weighted other components of M1 according to his estimates of their importance in financing end-product GNP.

In times of financial innovation, movements in M_Q are very different from movements in M1. As the upper panel of the chart shows, growth in real M_Q during most of the past year has been significantly lower than that of real M1. Between the fourth quarter of 1982 and July 1983, for instance, real M1 grew at a 12.5% annual clip, while real M_Q rose at a 9.8% annual rate. Had M1 grown at the slower rate over that same period, it would have been nearly $10 billion lower in nominal terms by July. That is roughly the amount of M1 growth the FOMC "forgave" last July when it rebased the 1983 target range for M1. Put another way, the growth difference between the two aggregates over that period reflects rapid expansion of the less-transactions-oriented accounts. Since July, growth in M1 and M_Q have begun to converge, as shown by the fact that the gap between them is no longer widening. That suggests that M1's ad-



Note: Money growth rates are twelve-month percentage changes adjusted for inflation.

The real rate is defined as the one-year, constant-maturity Treasury yield less the change in the personal consumption deflator over the preceding twelve-months.

justment to the new accounts may have substantially run its course.

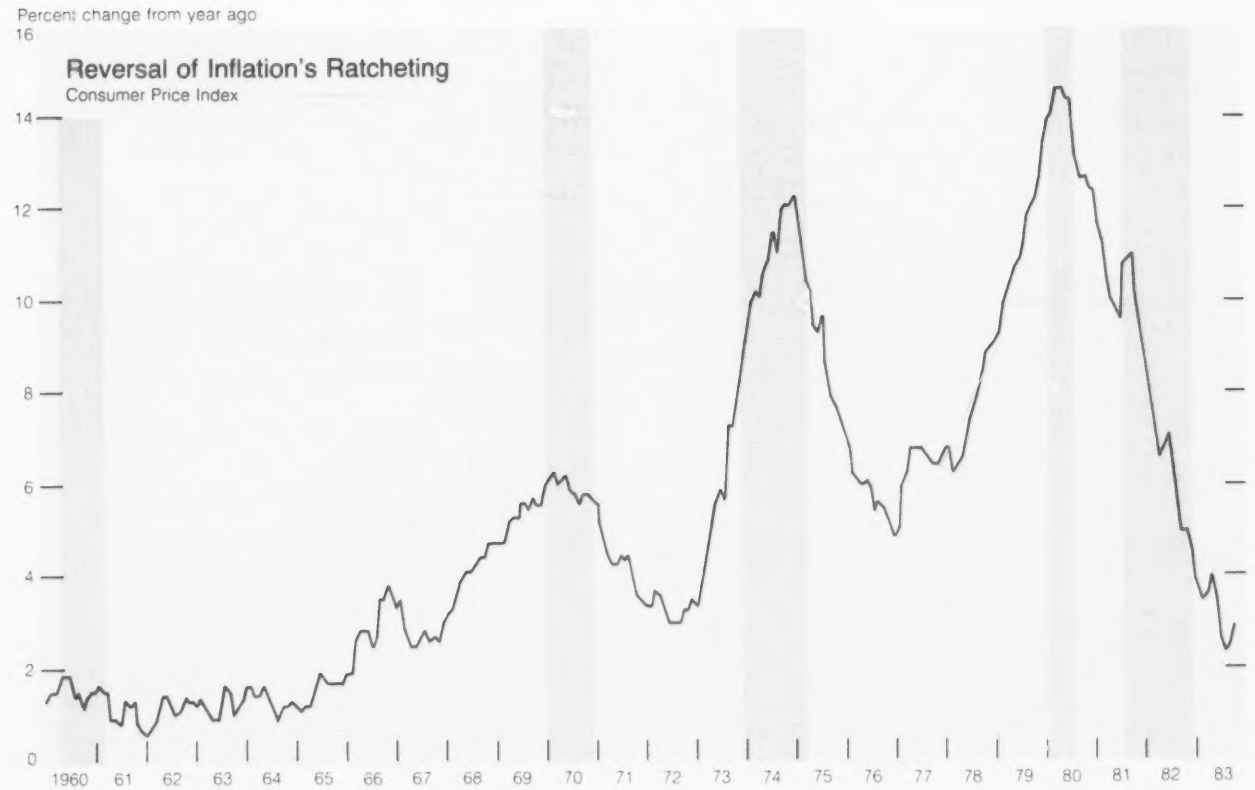
One advantage of M_Q has been its more stable and predictable velocity or "turnover rate." M1 velocity, which atypically failed to increase in the early phase of economic recovery, has risen recently. To be sure, while M1 velocity rose at a 2.2% annual rate in the third quarter, it has declined, on average, since the beginning of the recovery. Meanwhile, M_Q velocity—because it adjusts for some of the financial innovations that have recently distorted M1—has performed more as M1 velocity used to behave. In the first three quarters of the current recovery, M_Q velocity rose at a 1.3% annual rate.

The year 1983 by no means marks the first departure of M1 velocity from a relatively stable trend. In 1975-76, for example, M1 velocity soared at about twice its 3.2% trend rate of increase. And in 1980-81, M1 velocity growth became erratic, as nationwide NOW accounts were introduced. M_Q velocity, meanwhile, did not behave as erratically in either of those periods.

How good a guide?

Marked instability in the velocity of any aggregate makes it difficult for Fed officials to establish an appropriate growth rate for that aggregate. Indeed, the aberrant behavior of M1 velocity has been creating great uncertainty as to whether the tentative range established by the Fed for 1984 M1 growth is appropriate. With M1 velocity taking on a more "normal" look, that concern is lessening. However, it has not entirely evaporated, and that means that a measure such as M_Q, with a more logical conceptual grounding than M1, may have significant informational content in helping the Fed assess the appropriateness of its policy stance.

None of this is to say that M_Q should be enshrined as the perfect guide for future policy. For one thing, the estimates are still crude and need refinement. For another, in periods when deposit accounts are not changing so radically, M_Q—looked at over several quarters—will not convey signals to policymakers and Fedwatchers that are much different from those conveyed by M1. But the recent experience does point up the usefulness of looking at a statistic like M_Q in times of financial innovation.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research

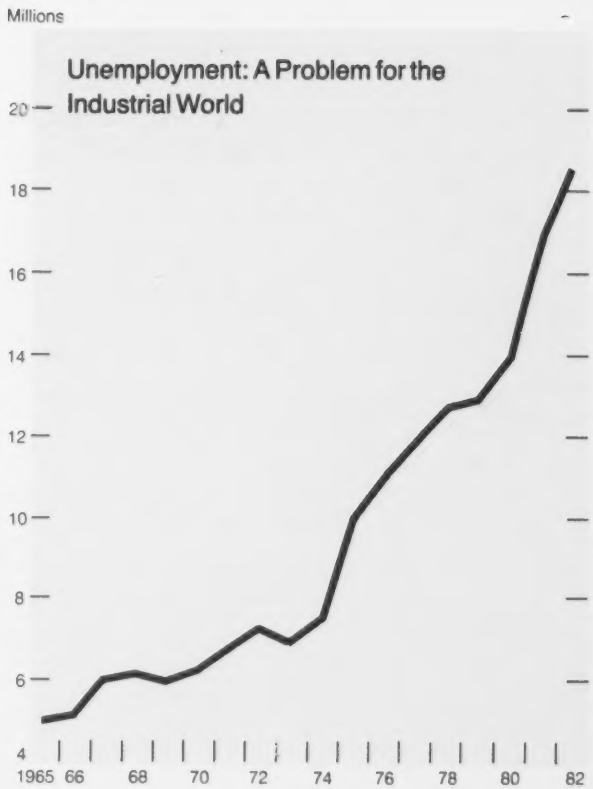
continue the anti-inflation battle. Significantly, the policy-setting Federal Open Market Committee (FOMC) is planning only moderate reductions in monetary-growth targets for 1984. And the FOMC's "central tendency" ranges for nominal GNP—which presumably represent judgments as to what FOMC members regard as acceptable—point to an expansion of 9% to 10% during 1984.

A 9%-to-10% outcome for nominal GNP next year—in line with the 1983 outcome—would be too high to be consistent with further disinflation in the economy. Neither the GNP central-tendency values nor the monetary objectives resemble the bitter price-restraining medicine administered to the economy from 1979 to 1982.

How the money-growth targets, if adhered to, will affect the economy in the coming year hinges in large part on velocity—that is, the frequency with which money balances "turn over" in financing purchases of goods and services. The behavior of velocity has been unusual lately—and no one can be confident that it is no longer a "wild card." If, for example, M1 velocity remains flat, as it has been on average this past year, then the 1984 4%-to-8% range for the growth of M1 would be restrictive. With inflation running at roughly 5%, even the upper bound of this range would sharply limit growth in real output. If, on the other hand, M1 velocity were to resume its normal 3% rate of increase, the monetary growth targets could well be very generous in the sense that nominal-GNP growth of 9% to 10% could be easily financed.

Uncertainty about velocity is a key reason, of course, why the Federal Reserve abandoned rigid money targeting in favor of a much more discretionary operating mode. Flexibility itself, however, is not a policy, and a need does exist for the Federal Reserve to give new definition to what it intends to do by way of long-term strategy. At the moment, Fed observers are left wondering what is feasible, and conviction has lessened in financial circles—and more generally—that inflation a few years ahead will be any lower than it is now. Indeed, considerable worry exists that the trough of inflation has been passed for the indefinite future—especially because monetary growth, by any measure, has been substantial during the past year. This is not a promising environment for encouraging disinflationary wage and price behavior. The FOMC's February 1984 review of its 1984 target ranges for money and its economic objectives could provide the opportunity for a restatement of intentions.

The Fed's task in reestablishing a credible disinflationary monetary policy would obviously be a great deal easier if fiscal policy were not an independent source of concern about the future. That is because fear continues to be widespread that large Treasury borrowings ultimately will provoke financial-market tensions (and force the Fed into significant debt monetization) once private credit demand revives fully.



Note: Data are for major industrial nations excluding the United States.

Those in Washington who are unwilling for whatever reasons to address the budget problem now are taking a substantial risk with the economy's longer future. With luck, trouble may not arise until the post-election period, when it may well be easier to muster support for tough measures. Counting on that, however, is hardly prudent.

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